U.S. Senate
Republican Policy
Committee

Larry E. Craig, Chairman
Jade West, Staff Director

No. 99

Legislative Notice

Editor, Judy Gorman Prinkey

October 2, 1998

H.R. 10 — The Financial Services Act of 1998

Calendar No. 588

Reported September 18, 1998, from the Committee on Banking, Housing, and Urban Affairs, by a vote of 16-2 (Senators Gramm and Shelby voting nay). S. Rept. 105-336, additional views filed.

NOTEWORTHY

- The Majority Leader has filed cloture on the motion to proceed to H.R. 10. A vote is expected on Monday, October 5, 1998 at 5:30 pm. H.R. 10 modernizes financial services and eliminates the barriers preventing banks, insurance companies, and securities firms from affiliating.

- An amendment to the reported bill is expected to be offered by the Managers. This amendment would address the agreement reached between the Independent Insurance Agents of America and the American Bankers Association regarding the sale of insurance, agreements reached with the Securities Exchange Commission, and technical corrections.

- The Administration has indicated it would veto the bill because regulatory authority over financial institutions was vested primarily with the Federal Reserve Board, not the Office of the Comptroller of the Currency under the auspices of the Treasury Department. Negotiations are ongoing to address this dispute.

- One of the major sticking points for the bill is the application of the Community Reinvestment Act of 1977 (CRA) to Wholesale Financial Institutions (or woofies). These financial institutions are not permitted to accept deposits under $100,000 and will not have federal deposit insurance. Opponents argue that CRA was justified, in part, by the benefits of federal deposit insurance provided to financial institutions, and that this expansion is not justified. CRA opponents have vowed to use all procedural options available to them to fight enactment of H.R. 10 if the CRA provisions remain in the bill. For further discussion, see a September 24, 1998, Dear Colleague from Senators Shelby and Gramm.

BACKGROUND

H.R. 10 attempts to make needed reforms to outdated financial services statutes that came into existence during the Depression. Globalization of financial services, developments in technology, and changes in the capital markets have rendered existing laws obsolete. Current laws block affiliations between and among banks, securities firms, and insurance companies. Banks are further precluded from offering most securities and insurance products. The current framework was set by the 1933 Glass-Steagall Act (which required the separation of commercial banking and investment banking) and the 1956 Bank Holding Company Act (which required the separation of banking and insurance). The intent of the legislation was to prevent banks from "gambling" on risky ventures with FDIC-insured deposits. Originally intended to protect the financial system by insulating commercial banking from other forms of risk, these laws now hamper the ability of financial institutions to diversify their products and reduce incentives to develop new and more efficient products and services. H.R. 10 would remove the restrictions on banks affiliating with securities and insurance firms (and vice-versa) without removing any prudential safeguards needed to fully protect the FDIC insurance funds.

HIGHLIGHTS

H.R. 10 provides for the affiliation between banking and other forms of financial services and commercial enterprises. The Senate bill is similar to the House bill, with some modifications. Following are the bill's four main areas of reform:

- **Financial Holding Companies.** H.R. 10 repeals the anti-affiliation provisions of the 1933 Glass-Steagall Act and the 1956 Bank Holding Company Act and makes other changes in law to allow for the merger of banking, insurance, and securities organizations under a holding company structure. Under H.R. 10, financial holding companies ("FHCs") will have broader powers than traditional bank holding companies, which are generally prohibited from owning or controlling non-banking companies. FHCs are authorized to own any business that is "financial in nature." Finally, the bill authorizes securities and insurance firms to own Wholesale Financial Institutions (WFI), a new type of institution which permits securities and insurance firms to own a banking institutions with access to the federal payments system and the discount window with less regulatory oversight. A wholesale financial holding company may own only a wholesale financial institution, which is a bank that does not accept FDIC-insured, retail deposits (only deposits of $100,000 or more).

- **Securities Functional Regulation.** The bill establishes functional regulation of bank securities activities. Banks currently enjoy a complete exemption from Securities and Exchange Commission (SEC) regulation as a broker-dealer because, as a general rule, they can not engage in the securities business. The bill establishes general exemptions designed to allow banks to continue to engage in traditional bank securities activities.

- **State Law and Insurance Sales.** States have always been the primary regulator of insurance sales and underwriting. A recent Supreme Court decision in *Barnett Bank of Marion County v. Nelson* has preempted this authority with respect to National Banks. H.R.10 provides a "safe-harbor" as to how states may regulate insurance activities of National Banks and their affiliates without being preempted. Generally speaking, laws that are not protected under the safe harbor can be challenged if they have a discriminatory impact on National Banks.

- **Thrift Charter.** The Senate bill makes changes to the House-passed bill, and prohibits any company engaging in commercial activities from directly or indirectly acquiring control of a thrift after September 3, 1998. Existing holding companies and those that form pursuant to an application filed on or before September 3 may continue to engage in any commercial activity of affiliation, subject to certain requirements.

BILL PROVISIONS

Title I — Facilitating Affiliation Among Securities Firms, Insurance Companies, and Depository Institutions
Subtitle A — Financial Holding Companies

Financial Holding Companies. The bill repeals the provisions of the Glass-Steagall Act that restrict the ability of banks and securities underwriters to affiliate with one another and creates a new type of bank holding company called a "financial holding company." Banks, securities firms, and insurance companies will be able to affiliate with one another through the financial holding company model. These companies will be allowed to engage in activities that are "financial in nature" including: lending and other traditional bank activities; insurance underwriting; providing financial and investment services; securities underwriting and dealing; merchant banking; and other any activity that the Board may approve as "financial" or "incidental" to a financial activity. The bill provides for the regulation of the new financial holding companies by the Federal Reserve Board. The bill also provides for functional regulation of activities; that is, similar activities should be subject to the same regulatory scheme.

To engage in the new financial activities allowed under the bill, all banks affiliated under the holding company must be well-capitalized, well-managed, and have at least a satisfactory Community Reinvestment Act (CRA) rating. Opponents of this CRA provision argue that it represents a major expansion of the enforcement authority of bank regulators. (For further discussion, see a September 24, 1998, Dear Colleague from Senators Shelby and Gramm).

Operation of State Law/Insurance Sales. Under current law, national banks and their operating subsidiaries may sell insurance in a town with 5,000 people or fewer. Banks have used this exception to the general prohibition on insurance sales to launch major insurance operations. Courts have upheld the Office of the Comptroller of the Currency's (OCC) authority to preempt state regulations with respect to national bank insurance sales. This bill prohibits states from "preventing or significantly interfering" with affiliations between banks and insurance firms or with bank insurance activities This means that banks may sell any type of insurance product

from any location, rather than the artificial construction of the "place of 5,000" requirement. The bill clearly establishes that the state insurance regulator is the appropriate functional regulator of insurance. The bill establishes a "safe harbor" of 13 areas in which a State can treat a bank's sales of insurance differently from the sales of unaffiliated entities. State laws enacted prior to September 3, 1998 that are not protected by the safe harbor can be challenged under the Supreme Court decision in *Barnett Bank v. Nelson.* As is currently the case, the OCC would receive judicial deference in its interpretation of national bank insurance powers. State laws passed after September 3 that are not covered by the safe harbor would be subject to a discriminatory impact test and could be preempted if they have a discriminatory impact on banks (even if they are neutral on their face). *Barnett's* preemption standard would continue to apply to these new laws, but the OCC would not be accorded deference in court.

Subtitle B—Streamlining Supervision of Financial Holding Companies

Streamlining Supervision of FHC's: The bill provides that the Federal Reserve Board may require any bank holding company or subsidiary to submit reports informing the Board of its financial condition, financial systems, and statutory compliance. To the fullest extent possible, the Board is directed to use existing examination reports prepared by other regulators, publicly reported information and reports filed with other agencies. The bill also authorizes the Board to examine each bank holding company and its subsidiaries. However, it may examine nondepository institution holding company subsidiaries only if the Board has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to the depository institution or is not in compliance with certain statutory and regulatory restrictions.

The Board is not authorized to prescribe capital requirements for any nondepository subsidiary of a financial holding company. In establishing or assessing holding company capital or capital adequacy guidelines, the Board also has been prohibited from taking into account the activities, operations, or investments of an affiliated investment company, unless the investment company is a bank holding company or unless a bank holding company owns more than 25 percent of the shares of the investment company.

Subtitle C —Subsidiaries of National Banks

Permissible Activities. The bill permits national bank subsidiaries to engage only in those activities permissible for national banks. Nonbank activities must be conducted through holding company affiliates and not through subsidiaries of the bank.

Subtitle D – Wholesale Financial Holding Companies/Wholesale Financial Institutions

Wholesale Financial Holding Companies. The bill authorizes the creation of Wholesale Financial Holding Companies. Such a company is defined as an FHC (1) that is predominantly financial, (2) controls one or more Wholesale Financial Institutions, and (3) is not affiliated with an insured banks or savings association. Wholesale Financial Holding Companies are subject to supervision of the Board, which may adopt capital adequacy rules for them. Commercial activities of Wholesale Financial Holding Companies are grandfathered, but may not be expanded through merger or consolidation.

Wholesale Financial Institutions (WFIs). The bill establishes national Wholesale Financial Institutions, which are chartered and regulated by the Comptroller of the Currency, and state Wholesale Financial Institutions, which are chartered and regulated by the States. Wholesale

Financial Institutions (WFIs) generally may not accept deposits of less than $100,000. Neither national or state WFIs may have deposit insurance.

WFIs must become members of the Federal Reserve System and have will have access to the discount window. Capital requirements for all WFIs may be established by the Board, which may also impose limitations on transactions with affiliates, set special clearing balance requirements, and take other actions to protect the payments system and the discount window. WFIs are subject to prompt corrective action by the Board and all WFIs must be well capitalized and managed.

Community Reinvestment Act. WFI's will be subject to the Community Reinvestment Act of 1977 (CRA), if they are affiliated with insured depository institutions or own insured branches. Opponents of this provision argue that this application of CRA to uninsured institutions is an unprecedented expansion of CRA. They argue that CRA was justified, in part, by the benefits of federal deposit insurance provided to financial institutions. In the case of WFI's, this link to federal deposit insurance does not exist. (For further discussion, see September 24, 1998, Dear Colleague from Senators Shelby and Gramm.)

Subtitle G — Federal Home Loan Bank System Modernization

The bill adopted a substitute for the House-passed provisions of the Federal Home Loan Bank System Modernization Act of 1998.

Expanding the Mission of the Federal Home Loan Bank System. The bill expands the types of assets which can be pledged as collateral for advances for certain institutions. Currently, only mortgage loans, mortgage-backed securities, Federal Home Loan Bank ("FHLBank") deposits, and certain other real estate assets may be used as collateral for advances. Many smaller banks are unable to hold sufficient mortgage loans to pledge as collateral. The bill would permit banks with assets of $500 million or less, to pledge small business, agriculture, rural development, and community development loans as collateral, and use the advances to fund these four types of loans.

At mid-year 1997, there were 6,047 commercial banks with under $100 million in assets and another 2,888 with assets of less than $1 billion. Thus, the change could effect about 7,000 to 8,000 banks.

Voluntary Membership. Changes current law to make Federal Home Loan Bank membership voluntary for savings and loan associations. Under current law, membership is mandatory. Making membership voluntary will change the status of 1,040 of the 6,300 members — those 1,040 members account for nearly 60 percent of the advances of the FHLB's. Any institution withdrawing from the system must repay all advances and may not rejoin the system for at least five years. Only 21 voluntary members withdrew from the system between January 1, 1993, and June 30, 1997.

Eligibility Requirements. The bill no longer requires small community banks with assets totaling less than $500 million to maintain a minimum of 10 percent of their assets in housing and housing related loans to remain members of the FHLBs, although larger institutions will still have to meet this requirement.

Management of Banks. The bill has taken the suggestions of the Government Accounting Office and removed certain governance powers from the Federal Housing Finance Board and given them to the Federal Home Loan Banks. These changes have to do with day-to-day operations of the Federal Home Loan Banks and were suggested by GAO to make the Finance Board more like other government sponsored enterprises and financial institution regulators.

Resolution Funding Corporation (REFCorp). The bill changes the fixed REFCorp obligation of the system from a fixed $300 million to a percentage of income. This action is needed to allow the Federal Home Loan Banks to reduce their levels of non-mission-related investments. Changing the REFCorp formula removes part of the economic incentive driving the FHLB System's current investment practices.

Title II — Securities Functional Regulation

Subtitle A — Brokers and Dealers

The bill allows banks to underwrite municipal revenue bonds (they may currently underwrite general obligation bonds). The bill requires "functional regulation" of financial activities. This means that, as a general matter, securities activities will be regulated by the Securities and Exchange Commission under federal securities laws, and insurance activities will be regulated under state insurance laws. To achieve this, H.R.10 requires certain bank securities activities to be "pushed-out" of (i.e., moved out of) the bank and into a registered broker-dealer affiliate. National banks may continue to engage in a number of traditional banking activities that involve securities, including: trust and fiduciary services; government securities transactions; and a limited number of securities trades for customers. The bill gives the SEC the primary role in determining if a new "hybrid" product offered by a bank is a to be sold directly through the bank or through a broker-dealer. Federal banking regulators, jointly with the SEC, must develop consumer protection regulations governing sales practices of banks for securities and insurance products. The bill also defines broker, dealer, and derivative instrument for purposes of this Title.

Subtitle B — Bank Investment Company Activities

This subtitle amends the Investment Advisors Act and the Investment Company Act to address issues and potential problems that arise from affiliated entities performing custodial/trustee, banking, brokerage or advisory services to mutual funds.

Custody of Investment Company Assets by Affiliated Bank. The bill authorizes the Securities and Exchange Commission to adopt rules and issue orders prescribing the conditions under which a bank, or affiliated person of a bank, may serve as the investment company's custodian. The bill authorizes the SEC to prescribe the conditions under which a bank may serve as trustee or custodian of the trust. The bill also expands the fiduciary responsibilities and the liabilities of a custodial bank that is affiliated with a fund's advisor.

Lending to an Affiliated Investment Company. The bill makes it unlawful for any affiliated person of an investment company to loan money or other property to an investment company in contravention of any SEC rule or order.

Independent Directors. The bill extends current statutory regulations to any bank as well as its affiliates and subsidiaries. The bill limits the number of "interested persons" who may serve on

the board of an investment company and uses the interested person concept to minimize conflicts of interest.

Additional SEC Disclosure Authority. The bill prohibits persons who issue or sell the securities of a registered investment company from representing or implying that the company or securities are insured by the FDIC, or are guaranteed by any insured depository institution.

Removal of the Exclusion from the Definition of Investment Adviser. The bill amends the definition of "investment adviser" so as to make banks and bank holding companies that advise investment companies subject to the same regulatory scheme as other investment company advisers.

Treatment of Bank Common Trust Funds. The bill codifies a current, long-standing SEC position regarding these trust funds.

Investment Advisers Prohibited from Having Controlling Interest in a Registered Investment Company. Investment Advisers are prohibited from having a controlling interest in a registered investment company.

Subtitle C-- Securities and Exchange Commission Supervision of Investment Bank Holding Companies

The bill creates a new supervised investment bank holding structure (IBHC) under federal securities laws, which is designed to implement a new concept of SEC supervision of broker-dealer holding companies that are not affiliated with banks. This alternative is made available to any company that controls two or more broker-dealers and is not affiliated with an WFI, an insured bank or thrift, or certain foreign banks or companies. IBHCs may affiliate with certain uninsured banks, credit card banks, or so-called "non-bank banks". The bill outlines the guidelines and procedures by which the SEC will supervise such holding companies.

Title III -- Insurance

In recent years, the Comptroller of the Currency (the national bank regulator) has aggressively preempted a number of state insurance laws that effect national banks. H.R. 10 recognizes the legitimacy of state regulation of insurance and establishes specific guidelines for state regulation of national Bank insurance activities. States may regulate the insurance agency activities of banks so long as the regulation is of a type covered by the bill's "safe harbor" provisions (e.g. consumer protection, anti-tying or full-disclosure laws), or if the state regulation does not restrict or significantly interfere with the ability of a bank to sell insurance. Specific provisions of this title are outlined below.

Subtitle A—State Regulation of Insurance

Mandatory Insurance Licensing Requirements. The bill states that no person or entity may provide insurance in a state as principal or agent unless that person or entity is licensed by the appropriate insurance regulator of the state.

Insurance Underwriting in National Banks. The bill prohibits national banks and their subsidiaries from underwriting insurance except for authorized products.

Title Insurance Activities of National Banks and their Affiliates. The bill prohibits a national bank from selling or underwriting title insurance but grandfathers those activities in which a bank was actively engaged before enactment.

Expedited and Equalized Dispute Resolution for Financial Regulators. The bill establishes an expedited and equalized dispute resolution mechanism to guide the courts in deciding a regulatory conflict between a state insurance regulator and federal financial regulator regarding whether a product is or is not an insurance product. Either party may file an action in federal appeals court, and the court must render a judgment within 60 days.

Consumer Protection Regulations. The bill directs federal banking regulators to issue final consumer protection regulations within one year to govern the sale of insurance by any bank, or any person on behalf of a bank.

Certain State Affiliation Laws Preempted for Insurance Companies and Affiliates. The bill preempts discriminatory state anti-affiliation laws.

Redomestication of Mutual Insurers. Unlike the House bill, the Senate bill does not allow mutual insurance companies to redomesticate to another state and reorganize into a mutual holding company or a stock company.

Subtitle B– National Association of Registered Agents and Brokers

The bill establishes the National Association of Registered Agents and Brokers (NARAB) as a non-profit private corporation under the laws of the District of Columbia. NARAB's purpose is to establish uniform licensing, appointment, and continuing education requirements for insurance agents. NARAB must preserve the rights of States to license, supervise, and discipline insurance producers and to prescribe and enforce laws and regulations relating to insurance-related consumer protection and unfair trade practices.

Board of Directors and Membership in NARAB. The bill states that membership in NARAB is voluntary and does not affect the rights of a producer under each individual state license. Any state-licensed insurance producer is eligible to join the organization. The NARAB board will consist of seven members appointed by the National Association of Insurance Commissioners (NAIC), at least four of whom must have significant experience with the regulation of commercial insurance lines in the 20 states in which the greatest dollar total of commercial insurance is placed in the United States. The officers of NARAB may not be elected nor appointed for more than three years. Only NAIC members may chair the board of directors.

NARAB must adopt bylaws and file them with the NAIC. When disciplinary action is taken against one of the members of NARAB, the organization must provide notice to the members and the NAIC, which may review or overturn such a decision. The bill allows the NARAB to impose application and membership fees, including reimbursement to the NAIC for its expenses.

Oversight and Liability of NARAB. The bill allows the NAIC, after notice and hearing, to examine and inspect the records of NARAB and require the organization to furnish it with any

reports. The bill clarifies that NARAB is not an insurer or insurance producer. NARAB and its directors, officers, and employees are not liable for any action taken or omitted in good faith.

Title IV – Unitary Savings and Loan Holding Companies

Prevention of Creation of new Savings and Loan Holding Companies with Commercial Affiliates. The Senate bill makes changes to the House-passed bill and prohibits any company engaging in commercial activities from directly or indirectly acquiring control of a thrift after September 3, 19998. The bill also prohibits any unitary thrift holding company from engaging in commercial activities (unitary thrift holding companies are otherwise allowed to engage in an unlimited amount of commercial activities). Existing holding companies and those that form pursuant to an application filed on or before September 3 may continue to engage in any commercial activity of affiliation, subject to certain requirements. This provision is intended to prohibit any company engaged in commercial activities from acquiring a thrift after September 3 or through some type of merger.

Title V— Financial Information Privacy

The bill adopts the Financial Information Privacy Act which addresses the threat to financial privacy posed by an emerging industry of "information brokers." The bill authorizes criminal and civil penalties for a person who fraudulently obtains consumer information from a financial institution.

Title VI—Miscellaneous

The bill contains a number of miscellaneous provisions, including a provision on grand jury proceedings; a sense of the Committee regarding Subchapter S of the Internal Revenue Code; investments in government sponsored enterprises; and repeal of savings bank provision in the Bank Holding Company Act.

ADMINISTRATION POSITION

While no official Statement of Administration Position is available, White House Chief of Staff Erskine Bowles sent a letter to the Banking Committee Chairman prior to Committee markup indicating that the President would veto H.R. 10 because the regulatory structure gives the Federal Reserve Board, not the Treasury Department, authority over the regulation of financial institutions. That veto threat was reiterated on October 1, 1998 in a *Wall Street Journal* article.

COST

A cost estimate prepared by the Congressional Budget Office is not yet available for this bill. A cost estimate was made available on September 12, 1998, for H.R. 10 as reported by the House

Committee on Banking and Financial Services. That bill was modified before it went to the floor and was further modified by the Senate Banking Committee, therefore, that estimate would not apply to the Senate bill.

OTHER VIEWS

Senator Mack. Filed additional views expressing concern with the Community Reinvestment Act (CRA) application to Wholesale Financial Institutions.

Senator Allard. Filed additional views expressing pleasure that the Committee included language supporting expansion of Subchapter S of the Internal Revenue Code to financial institutions.

Senator Grams. Filed additional views expressing concern about the CRA language and the treatment of unitary thrift holding company.

Senators Sarbanes, Dodd, Kerry, Bryan, Boxer, Moseley-Braun, Johnson, and Reed. Filed additional views expressing concern that the bill does not adequately address the protection of a customer's personal financial information, and eliminated the life-line banking provision included in the House.

Senator Reed. Filed additional views supporting the Office of the Comptroller of the Currency, not the Federal Reserve Board as the regulator of financial services and that the bill does not go far enough to promote affordability and access to retail banking services.

POSSIBLE AMENDMENTS

Shelby/Gramm. Re: Community Reinvestment Act.

Gorton. Re: Unitary thrifts.

Wellstone. Reinstate lifeline banking provisions.

Staff contact: Candi Wolff, 224-2946